No. 12845.

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

THE STUART COMPANY,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

OPENING BRIEF IN BEHALF OF THE STUART COMPANY, PETITIONER.

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Jurisdiction.

This Petition was filed to review a decision of The Tax Court of the United States involving income tax, declared value excess profits tax and excess profits tax liability of Petitioner for the years ended March 31, 1943, March 31, 1944, and March 31, 1945.

Notice of deficiency was mailed to Petitioner on August 16, 1946 [R. 12-23], and the Petition for Redetermination was filed with The Tax Court on November 12, 1946 [R. 6-23]. The Petition was filed pursuant to Sections 272(a)(1) and 729(a) of the Internal Revenue Code.

The Memorandum Findings of Fact and Opinion of The Tax Court, which are not reported, were entered on June 28, 1950 [R. 39-59], and the decision was entered on September 22, 1950 [R. 60]. Petition for Review was filed by The Stuart Company and notice thereof served upon counsel for Respondent on December 21, 1950 [R. 642-650].

The income tax, declared value excess profits tax and excess profits tax returns of Petitioner for each of the years ended March 31, 1943, March 31, 1944, and March 31, 1945, were all filed with the Collector of Internal Revenue for the Sixth District of California at Los Angeles, California [Petitioner's Exs. 2, 3 and 4]. The Petition for Review was filed pursuant to Section 1142 and jurisdiction is invoked under Section 1141 of the Internal Revenue Code.

Statutes Involved.

Internal Revenue Code:

"Sec. 23. Deductions From Gross Income.

In computing net income there shall be allowed as deductions:

(a) Expenses.—

(1) Trade or business expenses.—

(A) In general.—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business * * *."

Statement of the Case.

The Tax Court was called upon to determine whether Petitioner, The Stuart Company, under Section 23(a)(1)(A) of the Internal Revenue Code above quoted, was entitled to deduct sums aggregating $197,700.00 paid by Petitioner to The Vita-Food Corporation under an "Agreement of Settlement of Litigation and Cancellation of Contract" dated November 28, 1942.

The Tax Court held that Petitioner was entitled to deduct the sum of $75,000.00 but was not entitled and never will be entitled to deduct the balance of $122,-700.00, upon the theory (which Petitioner believes to be erroneous) that the latter sum was paid for the purchase of a trade-mark [R. 59]. Both the taxpayer and the Commissioner of Internal Revenue have petitioned this Court to review said decision. The taxpayer, The Stuart Company, will be referred to herein as the Petitioner.

Petitioner was incorporated under the laws of the State of California on March 27, 1941 [R. 183]. Prior to its incorporation, there had been preliminary negotiations between Petitioner's principal officer and shareholder, Arthur Hanisch, and Maxwell H. Lewis, the principal officer of The Vita-Food Corporation [R. 118]. It was the understanding that The Vita-Food Corporation was to manufacture and sell to Petitioner vitamin products, which were to be sold and distributed nationally by Petitioner [R. 109].

On May 5, 1941, Petitioner, The Vita-Food Corporation and Arthur Hanisch, as an individual, entered into a formal contract setting forth prices, quotas, default provisions and other rights, restrictions and liabilities [Petitioner's Ex. 8]. The contract was for a period of 10 years, during which time Petitioner was obliged to purchase all vitamin products from The Vita-Food Corporation at certain specified prices. The prices at which the products were to retail were likewise specified. Petitioner was granted the exclusive right to sell said vitamin products under trade-marks, including "The Stuart Formula" and "Vitaplex," which trade-marks the contract specified were to belong to The Vita-Food Corporation; but the contract further provided that if Petitioner did not sell certain specified quotas of the product during any 60-day period after November 1, 1941, such exclusive right could be terminated at the option of The Vita-Food Corporation [R. 44-47].

The price Petitioner was required under the contract to pay for products to be sold under the mark "The Stuart Formula" was 85 cents per pint bottle if its monthly purchases averaged less than 500 pint bottles per day; 84 cents if the purchases averaged between 500 and 750 bottles per day; 83 cents if between 750 and 1,000 bottles per day; 82 cents if between 1,000 and 1,500 bottles per day; and 81 cents if in excess of 1,500 bottles per day [Petitioner's Ex. 8, pp. 4-5]. The product was required to be retailed at $1.95 per pint bottle [Ex. 8, p. 3]. Petitioner's exclusive right to sell the product could be terminated by The Vita-Food Corporation if its purchases for any 60-day period did not average 1,500 pint bottles per day from November 1, 1941, to May 1,

1942, and if they did not average 2,000 pint bottles per day after May 1, 1942 [Ex. 8, p. 5].

Petitioner's operations under the contract resulted in losses aggregating $15,451.56 during the first 18 months [R. 55; Ex. 7]. During the first 11 months after the contract was executed (or to the end of the fiscal year ended March 31, 1942) it purchased vitamin products at a cost of $154,271.48, which, at the contract price of 85 cents per bottle, represented the purchase of approximately 180,000 pint bottles [Ex. 7]. This was at an average rate of but slightly in excess of 500 bottles per day. It sold said 180,000 bottles for $223,124.50 [Ex. 7], or for approximately $1.25 per bottle. This resulted in a gross profit for the period of approximately $69,000.00, or roughly 40 cents per bottle.

Similarly, during the seven months from April 1, 1942, to October 31, 1942, Petitioner purchased vitamin products from The Vita-Food Corporation in the sum of $143,495.51 [Ex. 7], which at 85 cents per bottle represented the cost of approximately 170,000 bottles. This would represent an average daily rate of purchases of roughly 800 bottles per day; whereas Petitioner's minimum quota was 2,000 bottles per day, in default of which its exclusive license could be terminated by The Vita-Food Corporation. Petitioner sold the 170,000 bottles in this seven-month period for $214,489.37 [Ex. 7], or for roughly $1.25 per bottle.

The foregoing figures are all approximate, but they illustrate two vital points: (1) the minimum quota appeared so unrealistically high that Petitioner would always remain at the mercy of The Vita-Food Corporation

and the prospect that the latter would terminate Petitioner's exclusive rights; and (2) the set price to the Petitioner was such that its gross profit apparently could never exceed about 40 cents per bottle, and this margin of gross profit over an 18-months' period had proved insufficient to cover its direct operating expenses and overhead. Petitioner was convinced that it could not operate at a profit as long as the contract was in effect [R. 326-327].

Then, too, Petitioner had experienced difficulty with some of the product, which had become gaseous from exposure to the sun and exploded or ran over the sides of the bottles [R. 47] and had also experienced short counts on the tablet preparations [R. 328]. Relationships between the parties became strained [R. 327-329]. Then in September and October, 1942, Petitioner learned for the first time that there was nothing new, novel or secret in the product being purchased from The Vita-Food Corporation; that there was no unique formula involved in any sense of the term; that a molasses base for such a product was improper in the pharmaceutical field, due to its fermentation properties; and that a better product containing the same vitamin content could be purchased from large and reputable pharmaceutical houses for at least one-third less than Petitioner was bound by contract to pay The Vita-Food Corporation, or from 54 to 60 or 65 cents per bottle [R. 49, 135, 143, 174-176, 257, 293-294, 328]. Thus, Petitioner's officers believed that if it were released from its obligation to buy its products exclusively from The Vita-Food Corporation at prices established by contract it could immediately increase its gross profit from 40 cents per bottle to approximately 65

cents per bottle—an increase of roughly 60 per cent, which would mean the difference between profitable operations and a losing venture.

While the original contract of May 5, 1941, recited that any and all trade-marks should be the property of The Vita-Food Corporation, the latter's name did not appear on labels, literature or correspondence used by Petitioner in its business, and was unknown to the public [R. 130]. The whereabouts of its manufacturing plant was never disclosed even to Petitioner [R. 169]. The trade-mark "The Stuart Formula" was registered with the United States Patent Office by The Vita-Food Corporation, but Petitioner believed and contended that such registration was fraudulent [R. 323 and 424-425], for the reason that said trade-mark was used exclusively by Petitioner and was not used by The Vita-Food Corporation.

On October 8, 1942, The Vita-Food Corporation served written notice upon Petitioner terminating its exclusive right to sell under said contract, in view of Petitioner's failure to meet its quotas, the termination to be effective 60 days thereafter. The notice stated that in all other respects the contract was to remain in full force and effect [R. 49]. This necessarily included the continuance of Petitioner's obligation to "handle no other products than those produced by The Vita-Food Corporation." Petitioner acknowledged receipt of such notice on October 12, 1942, stating that it would attempt to cure its

failure within the 60-day period, but would probably be unable to do so, and would regard the contract as terminated in its entirety [R. 49-50]; in short Petitioner then declined to concede the existence of any such intermediate procedure. It may be observed here that the contract contained two provisions granting The Vita-Food Corporation options to terminate: (1) paragraph 6 authorized The Vita-Food Corporation to terminate Petitioner's exclusive right if it failed to meet its quotas; and paragraph 19 authorized The Vita-Food Corporation to terminate the entire contract if Petitioner failed to meet its quotas [Ex. 8]. Thus, The Vita-Food Corporation sought to terminate only Petitioner's exclusive rights, while holding it to the other provisions of the contract, and Petitioner sought to be relieved of the entire contract.

Litigation was inevitable. Petitioner's counsel, Mr. Dunlap, was busy preparing a complaint to rescind the contract, but before it was filed, The Vita-Food Corporation, on November 25, 1942, filed suit against Petitioner seeking to enjoin it from using the trade-mark "The Stuart Formula" upon any product not manufactured by The Vita-Food Corporation and for general relief [R. 51]. Petitioner continued preparation of a cross-complaint seeking, among other things, a rescission of the contract upon several grounds.

In culmination of these difficulties an agreement captioned "Agreement of Settlement of Litigation and Cancellation of Contract" was executed on November 28,

1942, by Petitioner, The Vita-Food Corporation and Arthur Hanisch [Petitioner's Ex. 12], under which the litigation was dismissed with prejudice, the contract of May 5, 1941, was cancelled and terminated "as fully and to the same effect as though the same had never been executed," and each party released the other from any and all claims. Under the terms of said agreement, Petitioner agreed to pay The Vita-Food Corporation the sum of $197,700.00, as follows: $35,000.00 upon execution of the agreement, $40,000.00 at the rate of $4,000.00 per month, and $122,700.00 "on a royalty basis and as additional consideration for the execution of this agreement," at the rate of 7½ cents per unit of vitamin concentrates sold by Petitioner on and after October 1, 1943, under any and all trade names which might be employed [Petitioner's Ex. 12, p. 2].

As an incident to said agreement, The Vita-Food Corporation quitclaimed any interest which it might have in the trade-mark "The Stuart Formula" and agreed to make appropriate record assignment of the same if so requested [Petitioner's Ex. 12, p. 1]. Petitioner also quitclaimed any interest it might have in certain other names [Petitioner's Ex. 12, p. 4]. Petitioner made the cash and royalty basis payments, as called for by the agreement, and deducted the same upon its various returns as amounts paid to secure the cancellation of an onerous contract [Petitioner's Exs. 2, 3 and 4]. The Tax Court erroneously and arbitrarily allocated the sum

of $122,700.00 to purchase of the trade-mark "The Stuart Formula," which amount it declared must be capitalized, and treated the balance of Petitioner's total payment, the sum of $75,000.00, as being paid for cancellation of an onerous contract, which, of course, was allowed as a deduction from Petitioner's income [R. 59].

Immediately after the settlement agreement was executed Petitioner commenced the purchase of its vitamin products elsewhere. During the fiscal years ended March 31, 1944, and March 31, 1945, it sold 1,352,593 bottles at approximately $1.27 per bottle—or roughly the same price at which the former product had been sold; but its cost of such products averaged only 61 cents per bottle, as opposed to a cost in excess of 81 cents that would have been required under the cancelled contract [Exs. 3, 4 and 5]. As a result, Petitioner's gross profits during said two taxable years were roughly $300,000.00 greater than they would have been under the old contract—solely as a result of the cost differential. But under The Tax Court's decision the 7½ cents per bottle royalty it was required to pay The Vita-Food Corporation was not permitted as a deduction. Petitioner was subjected to income tax and excess profits tax during the year ended March 31, 1945, at the almost confiscatory maximum wartime rate of 80 per cent of its net income—the net income being computed without any deduction for said royalties, but including the full benefit derived by it from savings in cost through cancellation of the contract [R. 23].

Specification of Errors.

Petitioner relies upon the following Specification of Errors, being the same as its Statement of Points on pages 658-661 of the printed record:

1. The Tax Court erred in holding and deciding that $122,700.00 was paid by Petitioner under the cancellation agreement of November 28, 1942, for the purchase of a trade-mark "The Stuart Formula."

2. The Tax Court erred in allocating any more than a nominal portion of the total payment of $197,700.00 made by the Petitioner under the cancellation agreement of November 28, 1942, to the acquisition of any capital asset.

3. The Tax Court erred in failing and refusing to hold and decide that all of said $197,700.00 paid by Petitioner under the cancellation agreement of November 28, 1942, or at least substantially all thereof, was paid by Petitioner to secure cancellation of an onerous contract, and in further failing to hold the same is deductible as an ordinary and necessary business expense under Section 23(a) of the Internal Revenue Code.

4. The Tax Court erred in determining any deficiency in income tax, declared value excess profits, or excess profits tax for either the fiscal year ended March 31, 1944, or the fiscal year ended March 31, 1945.

5. The Tax Court erred in that its Findings of Fact and Opinion are not supported by, but are contrary to,

the evidence, to wit, The Tax Court found and held that Petitioner paid $122,700.00 for the trade-mark "The Stuart Formula," whereas the evidence established that the Petitioner, as the exclusive user of said trade-mark, had experienced increasing net operating losses over a nineteen-month period aggregating $15,451.56, that said trade-mark was of no value, that Petitioner regarded the trade-mark as in ill repute, that Petitioner was considering the adoption of a new trade-mark once it was freed of its contractual obligation to buy products only from The Vita-Food Corporation, that acquisition by Petitioner of whatever interest The Vita-Food Corporation had in said trade-mark was an inconsequential feature of the settlement agreement, and that Petitioner did not pay, and would not have paid, any but a nominal consideration for said trade-mark.

6. The Tax Court erred in that its Findings of Fact are inconsistent one with another, and its Opinion is contrary to its Findings of Fact, to wit, The Tax Court found that the stock of the Petitioner was worthless on the date of the settlement agreement, November 28, 1942, but notwithstanding this finding (which was amply supported by evidence) The Tax Court found and held that Petitioner, which had been the exclusive licensee with the sole right to use the trade-mark "The Stuart Formula," paid the sum of $122,700.00 for whatever interest The Vita-Food Corporation had in said trade-mark, thereby apparently (and erroneously) inferring that the trade-mark had sufficient value to justify such a price, which inference is repugnant to the finding that Petitioner's stock had no value on that date.

7. The Tax Court erred in disregarding and ignoring uncontradicted testimony of expert and other witnesses which established that the trade-mark "The Stuart Formula" had no value on the date of the settlement agreement, November 28, 1942, or at most a nominal value.

8. The Tax Court's Findings of Fact, Opinion and Decision are contrary to the recognized and settled rule of law, that a lump sum paid under a contract is to be allocated among the respective considerations received for such sum in accordance with the relative values of said respective considerations; and since the uncontradicted testimony in this record established that the trade-mark "The Stuart Formula" had no value or only a nominal value, The Tax Court erred as a matter of law in allocating any of the payments (or more than a nominal part) as the purchase price thereof.

9. The Tax Court's Findings of Fact, Opinion and Decision, in so far as they hold that Petitioner obligated itself to purchase the trade-mark "The Stuart Formula" in consideration of the sum of $122,700.00, are arbitrary and are based upon an erroneous interpretation of the settlement agreement of November 28, 1942, in that said agreement specifies that if Petitioner should abandon said trade-mark, as was actually under consideration by Petitioner, the trade-mark would become the property of The Vita-Food Corporation, but notwithstanding this the Petitioner would still have been liable under said contract to pay to The Vita-Food Corporation the said sum of $122,700.00.

10. The Tax Court erred in that its Opinion and Decision are contrary to law.

Summary of Argument.

The question presented to this Court is whether The Tax Court erred in allocating the sum of $122,700.00 to the purchase of the trade-mark "The Stuart Formula."

I. Petitioner was a party to the 10-year contract of May 5, 1941, which by November, 1942, had become a very onerous contract from Petitioner's standpoint, largely because (1) it was never able to meet the quotas set forth therein and was therefore at the mercy of the other contracting party, (2) the margin of gross profit which Petitioner was able to make under the terms of the contract was so low that its officers believed it could never operate at a profit thereunder, (3) its officers had come to the conclusion that the product it was bound to purchase under the contract was an inferior product, and (4) it had learned, contrary to assurances given to it at the time the contract was executed, that there was no unique formula involved in the product and that a better product could be obtained elsewhere at such a substantial savings in cost that its ratio of gross profits would increase at least 60 per cent. Petitioner's officers considered the trade-mark "The Stuart Formula" to be in ill repute and of no value whatever and had given consideration to the adoption of a new trade-mark and had even calculated the cost (at not to exceed $20,000.00) of making such a change. Such a change in name would have afforded Petitioner no relief from the onerous contract, since Vita-Food was contending that any trade-mark

adopted by Petitioner should become the property of Vita-Food. Notwithstanding gross sales of $437,000.00 over the 17-months' period ended October 1, 1942, Petitioner had sustained a net operating loss in excess of $15,000.00.

To secure relief from this onerous contract Petitioner was willing to, and did, pay to the other contracting party sums aggregating $197,700.00.

Under the "Agreement of Settlement of Litigation and Cancellation of Contract" Petitioner was relieved of its obligation to confine its merchandise purchases to The Vita-Food Corporation and therefore became free to obtain better products at much lower prices than it had been paying to The Vita-Food Corporation under its contract of May 5, 1941.

Under the settlement and cancellation agreement The Vita-Food Corporation "quitclaims without warranty * * * to the second party [Petitioner] the trade-mark 'The Stuart Formula.'" Vita-Food also agreed "to execute appropriate assignments, *if requested*," of the trade-mark registrations. In addition thereto The Vita-Food Corporation agreed to transfer to Petitioner 300 shares of its stock which had, under the agreement of May 5, 1941, been transferred to Mr. Lewis as representative of The Vita-Food Corporation.

Petitioner agreed to pay to The Vita-Food Corporation the total sum of $197,700.00, as follows:

(1) $35,000.00 upon execution of the contract;

(2) $4,000.00 per month over a 10-month period;

(3) $122,700.00 at the rate of 7½ cents per unit of vitamin concentrates as sold and marketed by Petitioner under any trade name used, beginning October 1, 1943, and continuing until the full sum of $122,700.00 had been paid.

The payment of this sum in the manner specified was not conditioned upon the assignment of the trade-mark, nor was it conditioned upon the use by Petitioner of said trade-mark. The Tax Court, without any evidence to support its findings, concluded that the sum of $122,700.00 was paid for the trade-mark "The Stuart Formula" and therefore treated this sum as a capital expenditure.

The Tax Court recognized the established law that the allocation of the contract consideration should be based upon the value of the properties and the benefits derived by Petitioner, since it accepted the testimony of Petitioner's witnesses with respect to the worthlessness of the 300 shares of Petitioner's stock and as a result thereof allocated no part of the contract consideration to this stock. However, The Tax Court erroneously ignored the uncontradicted testimony of Petitioner's witnesses with respect to the value of the trade-mark "The Stuart Formula."

II. The trade-mark in the hands of The Vita-Food Corporation was worthless as a matter of law and they had no legal right or effective ability to execute an assignment.

ARGUMENT.

I.

The Tax Court Erred in Allocating $122,700.00 of the Total Consideration Paid by Petitioner to The Vita-Food Corporation to the Trade-Mark "The Stuart Formula."

A. The Economic Benefits Petitioner Expected to Be Derived From the Cancellation of the Onerous Contract Preclude the Allocation of Any Substantial Sum to the Trade-mark.

The Tax Court concluded that Petitioner, under the contract of November 28, 1942, obligated itself to pay Vita-Food the sum of $122,700.00 for the purchase of the trade-mark "The Stuart Formula" at the rate of 7½ cents per unit of vitamin concentrates sold by the Petitioner after October 1, 1943 [R. 56].

Admittedly there is no direct evidence to support such an allocation of the total sum to be paid under the contract. Let us therefore inquire whether such a conclusion is supportable by any logical inference to be drawn from the evidence.

We desire to emphasize the fact that such payments "on a royalty basis" were to commence on November 15, 1943, with respect to sales made during the calendar month of October 1943. In other words, *these payments were not to commence until one year after the agreement of November 28, 1942.*

Yet, on the very next page of the agreement it was provided that if the trade-mark should be abandoned by Petitioner the ownership thereof would vest in Vita-Food [R. 54]. This provision was inserted in the agreement

for a very good reason, for it will be observed that Mr. Hanisch prior to the execution of the agreement had actually contemplated abandoning the trade-mark "The Stuart Formula" and had gone so far as estimating what it would have cost to adopt a new trade-mark and label and acquaint the trade with such change [R. 179-180].

It is reasonable to assume that any abandonment or change of the name, if that course were decided upon, would have occurred soon after the agreement of November 28, 1942, divorcing the parties—or long before the royalty payments were to commence. But the abandonment of the name would not have altered Petitioner's obligation to commence royalty payments the following year nor would it have reduced the sum of $122,700.00 which Petitioner was obligated to pay in this manner.

If, as The Tax Court inferred, the trade-mark was the all-important factor and if the parties were primarily interested in selling and purchasing the mark for $122,700.00, is it not most extraordinary that payments for the mark were not to begin until one year after the so-called purchase and sale? And is it not most unusual that Petitioner would purchase a mark for $122,700.00 which it believed could be abandoned in favor of another mark, equally suitable, at a cost of less than $20,000.00? And is it not strange that Petitioner obligated itself to continue paying for the mark, while at the same time providing that the mark would become the property of Vita-Food in the event of such abandonment?

We respectfully submit that these questions reveal that The Tax Court's inference completely lost sight of the factual situation actually existing when the settlement agreement was made.

The true situation, and the only logical conclusion to be drawn from it, must take into account the following facts:

By the original contract of May 5, 1941, Petitioner had obligated itself for a period of 10 years to buy all its vitamin products from Vita-Food at a basic price of 85 cents per pint bottle [Petitioner's Ex. 8]. The contract specified that for said 10-year period the retail selling price to the ultimate consumer should not exceed $1.95 per pint bottle. The result was that Petitioner, in order to leave profits for retailers, sold the product for approximately $1.25 per bottle. This left Petitioner with a gross profit of approximately 40 cents per bottle—a sum which was insufficient during 18 months of operation to cover its direct operating expenses and overhead. As a result it suffered losses as disclosed in the record.

Meanwhile, Petitioner learned for the first time that an equivalent or superior product could be purchased for as low as 54 cents per bottle [R. 176].

Imagine the frustration of a distributor, bound by a contract still having 8½ years to run under which its cost was set at 85 cents and its gross profit was limited to 40 cents per bottle, upon learning that it could acquire from other sources an identical product, or one which it believed to be superior, for 25 or 30 cents per bottle less than it was obligated to pay under the contract. By merely being relieved of its contractual obligation to purchase all products from Vita-Food, the Petitioner would be free immediately to increase its gross profit *on every bottle it sold* by 25 cents, representing an increase of 60 per cent over the gross profit to which it was limited under the contract.

Certainly it was good business, and Petitioner could well afford, to pay over to Vita-Food 7½ cents out of the increased 25 cents gross profit which it would immediately realize upon the sale of every bottle if it were freed of its contract.

When the 7½ cents royalty payments commenced in November 1943, there would still have remained 7½ years of the 10-year period of the original contract. In order to pay the sum of $122,700.00 at the rate of 7½ cents per bottle, Petitioner had to sell 1,636,000 bottles of vitamin products. The monthly sales from May 1941 to October 1942, when the royalty agreement was reached, had averaged about 19,500 bottles, or at an annual rate of approximately 234,000 bottles. Based upon such average sales to that date, it would require approximately 7 years of sales to pay $122,700.00 at the rate of 7½ cents per bottle. Based upon the then volume of business this would take the payments down to the approximate time the original 10-year contract otherwise would have terminated.

The inescapable conclusion is that the royalty payments represented consideration paid by Petitioner to be released, *for the final 7½ years of its contract,* from its obligation to buy goods only from Vita-Food at 85 cents per bottle. In other words, in anticipation of an immediate increase in gross profit of 25 cents per bottle, it was willing to pay over to Vita-Food, as consideration for the freedom which would make such increase possible, 7½ cents of such increase, retaining the balance.

This had nothing whatever to do with the trade-mark "The Stuart Formula"—it was a benefit realizable *solely*

by saving in cost which would inure to Petitioner if its onerous contract could be cancelled.

It is often declared that taxation is a practical matter. As a practical matter Petitioner went ahead immediately and during the taxable years before this Honorable Court it purchased vitamin products at approximately 60 cents per bottle and sold them at approximately $1.25 per bottle, exactly as it knew it could do. It thus realized the expected increase in gross profit of 25 cents per bottle over what its profit would have been under the Vita-Food contract. It has reported that additional 25 cents per bottle profit in computing its income tax and excess profits tax. It has sought to deduct against that 25 cents additional profit the expense it was put to in obtaining it—namely, the 7½ cents it was required to pay over to Vita-Food. As a practical matter, one would suppose that the tax should not be levied upon the gross increase of 25 cents, but only upon the net amount of gross profit —after subtracting the 7½ cents—which resulted from cancellation of the agreement.

But The Tax Court's decision is not practical. It is harsh. It taxes the gross increase of 25 cents and ignores forever the 7½ cents expense incurred to produce the 25 cents. Such a harsh result might be condoned if it were dictated by some technical statutory mandate. But, as we have seen, it resulted solely from an inference indulged in by the Court—the inference that $122,700.00 was paid for a trade-mark—which we believe is shown by the above analysis to be utterly at odds with reality. An erroneous inference should never be allowed to result in a harsh decision in the practical field of taxation.

We ask the Court to appraise the situation faced by Mr. Hanisch and Mr. Dunlap as it existed in October 1942. Both firmly believed that the trade-mark "The Stuart Formula" had little or no value. They had even calculated the cost of adopting a new name, at less than $20,000.00. The name had been used only one and a half years. Its use had resulted in losses to Petitioner. In some quarters the mark was in ill repute because the product had exploded.

On the other hand, they had just learned that they could have purchased a product at a savings in cost of at least 25 cents per bottle, so that at the then volume of business Petitioner would have made a profit of $99,000.00 instead of losses, or annual profits of about $65,000.00 [R. 176, 374-375]. Regardless of the name, with the contract still having 8½ years to run, they knew that solely as a result of the contract restrictions on their cost, they would lose $550,000.00 in profits over 8½ years which they could earn if they were only free to buy products from others (this based only on the volume of business then existing).

To be released from the obligations of that contract and also to be able to continue using the trade-mark Petitioner agreed to pay Vita-Food the sum of $197,700.00. We ask the Court: what was the great bulk of that sum paid for? To secure freedom so they could earn more than one-half of one million dollars over the remaining term of the contract? Or for the incidental trade-mark which they believed could have been replaced by an expenditure not exceeding $20,000.00? We respectfully believe the answer is so obvious that this Court can but reverse The Tax Court's arbitrary and erroneous determination.

Just as the 7½ cent royalty payments were consideration for being released from the cost burdens of the contract from and after October 1, 1943, so also we submit that the initial payment of $35,000.00 and particularly the monthly payments of $4,000.00—for the 10 months from the execution of the settlement agreement until the royalty payments were to commence—were consideration for the cost advantage Petitioner would realize during said 10-month period as a result of freedom from its contract.

B. The "Agreement of Settlement of Litigation and Cancellation of Contract" Clearly Indicates That the Trademark Was of Little Significance.

An examination of the "Agreement of Settlement of Litigation and Cancellation of Contract" [Petitioner's Ex. 12] clearly indicates that the trade name "The Stuart Formula" was considered by all parties thereto as having little significance. The caption of the contract negatives the idea that the trade name had any real importance. There is not one word in the text of the agreement which supports the contention that Petitioner was paying such a large sum—$122,700.00—for the trade name. At no place in the agreement do the words "buy," "sell" or "exchange" appear. Respondent's own witness—the attorney who assisted in drawing the agreement—testified that he intended the agreement to mean just what it said [R. 572]. The agreement clearly indicates that the signatory parties intended to "settle the litigation and cancel the contract."

Petitioner's reasons for cancelling the contract were, among others, that the quality of the product was inferior [R. 135] and that the price thereof to Petitioner was more than twice as high as good products which could be obtained elsewhere [R. 143], but primarily because under paragraph "7" of the agreement of May 5, 1941, Petitioner was obligated to continue to purchase all of its merchandise from The Vita-Food Corporation. Because of the defective products and the high prices which Petitioner was required to pay to The Vita-Food Corporation, Petitioner was unable to make a profit. In fact, The Tax Court found that "From the date of its organization on March 27, 1941, until October 31, 1942, the petitioner suffered net operating losses, as shown by its books, which totalled $15,451.56." [R. 55.] The Tax Court also found as a fact that the shares of stock of Petitioner were worthless on November 28, 1942 [R. 56].

How, under these circumstances, can it realistically be contended that $122,700.00 of the total payment should be allocated to the trade name "The Stuart Formula"? It is most unrealistic to assume that a trade-mark in use only about 18 months, with the resulting losses hereinbefore referred to, would have any such value. In *Ohio Oil Co. v. Commissioner,* B. T. A. Memo. Dec., Docket No. 100090, the Board summarily decided that a corporation which had been in business only 3½ years could have no good will, particularly since it had suffered losses during that time. Furthermore, it is extremely unrealistic to allocate such a large sum to the trade-mark since the

parties themselves, as indicated by the contract, attached so little importance to it. If the parties had really regarded the trade-mark "The Stuart Formula" as important they certainly would have so indicated in the contract; they would not have left it dangling, as they did, with the option on the part of the Petitioner to subsequently take it or leave it. It will be recalled that under the terms of the contract The Vita-Food Corporation agreed to "execute appropriate assignments of the trade-mark, *if requested.*" This clearly indicates that in the minds of the contracting parties the trade name "The Stuart Formula" had little significance. Whether Petitioner did or did not subsequently request the assignment of the trade-mark or whether Petitioner used or did not use the trade-mark had no effect upon Petitioner's obligation to pay the total sum provided for in the contract, which, as heretofore stated, was paid to settle litigation and for cancellation of the contract. The record indicates that it was approximately five months after the contract was signed that Petitioner requested the assignment of the trade-mark [Respondent's Ex. M].

C. The Allocation of an Aggregate Consideration to Capital and Expense Items Is to Be Based Upon Evidence of Value.

It is well established that where the parties to an agreement express an aggregate consideration to be applied to capital and expense items, but make no breakdown of the consideration as among themselves, the Court must make its allocation based upon evidence of value. In *Cleveland Allerton Hotel, Inc. v. Commissioner* (C. C. A., 6), 166 F. 2d 805, the Petitioner had paid the over-all consideration of $441,250.00 for the purpose of securing cancella-

tion of an onerous lease, but incidentally also acquired fee title to a piece of real estate. The Court reasoned and held as follows (pp. 806 and 807):

> "The petitioner argues that its primary purpose was to buy its way out of that portion of its leasehold obligation which was excessive and that its purchase of the fee was merely incidental to that purpose. * * * Its claim that the value of the land was no more than $200,000 is supported by credible and uncontradicted evidence, which the Tax Court finds establishes that if there were no lease to be considered the value of the land would be $200,000. The petitioner concedes that, neither in the negotiations to purchase nor in the contract which eventuated, was there any designation of consideration separately assignable to the purchase of the leasehold or to the reversionary interest in the land, but urges that such allocation has no bearing on the problem for if the transaction is to be viewed realistically, what it paid over and above the fair value of the real estate must necessarily have been paid to escape an excessive rental obligation. * * *
>
> * * * * * * * *
>
> If numerous admonitions that taxation is a practical matter, that taxing authority may look through form to substance, is not mere rhetoric where the taxpayer's interest is involved, and a working formula only when it is of advantage to the Treasury, it would seem to be clear that the petitioner paid all over $200,000 to escape from a burdensome lease, and should be able to write that off as an expense of doing business."

D. The Uncontradicted Evidence Clearly Establishes the Fact That the Trade Name "The Stuart Formula" Had No Value.

Petitioner, in conformity with the foregoing principle of law, offered evidence which is uncontradicted as to the value of the trade-mark "The Stuart Formula." Each one of the witnesses testified that the trade-mark had no value on November 28, 1942. Mr. Arthur Hanisch, President of Petitioner, testified as follows:

> "Q. (By Mr. Mackay): Well, what in your opinion was the fair market value of the trade name at that time?
>
> A. The trade-mark 'the Stuart formula'?
>
> Q. Yes.
>
> A. It had no tangible value to us whatever, insofar as—well, it had no realistic value. Let me explain it this way: As a matter of fact, we had considered using the name 'The Stuart Company' and calling it 'Stuart Vitamins' because of the bad repute of the product we had. However, I estimated what it would cost us to change the name of the product to a name like 'Stuart Vitamins,' and it would have cost us—and I have a figure, may I refer to that figure—I estimated that at the time we were considering making that change to a new name, and all of our men agreed that this would have been the cost, we would have had to make a notification to all the doctors [132] who were on our mailing list at that particular time, and also to our drug outlets. The number of doctors we had at that time was 17,428. The number of drug outlets we had was 6,746. Our estimate of what that cost would have been was predicated on this: Our men had to call on the doctors anyway. They would have informed

them verbally, so there was no added expense on that particular point. However, we felt that the mailing of advice to each one of our doctors—to each one of our drug stores would have been ample notification to make them aware that there had been a change. Those mailings through our experience have cost us six cents apiece, so that the total cost of that mailing would have been $4,713.00.

We also, at that time, had 11,700 bottles of merchandise on hand which would have had to be relabeled. There Lewis or the Vita-Food Corporation at that time was charging us 10 cents to do relabeling. For that reason we used the figure of a cost of 10 cents which would have involved changing this label to a new name, which comes out $1,170.00.

In addition to that there would have been the work and experience [*sic*]—art work of getting up our new labels with a new name, which we estimated at $1,000.00.

That is a total figure of $6,883.93, which I think is a very fair estimate.

But assume that you double or triple it. I would say that is an absolute outside figure of what a change to another name [133] would have involved." [R. 179-180.]

Mr. Donald Royce, President of the oldest investment house on the Pacific Coast, a witness with no interest in the Petitioner or outcome of the law suit, offered the following testimony:

"Q. (By Mr. Mackay): Would you assign any value at all to those intangibles, particularly a trade name, if the company showed no earnings?

A. We would not.

Q. Will you please examine Exhibit 19. That shows a loss to The Stuart Company for its first full year of operation of $6,462.14, and a loss for the period from April 1, [387] 1942, to October 31, 1942, of $8,989.42.

A. Under those circumstances, I am very confident there would have been no value, from the standpoint of a public distribution or sale to a private group, of that trade-mark.

Q. The record shows that The Stuart Company had carried on operations and sold products under 'the Stuart formula' trade name from the beginning at April 1, 1941, to November 28, 1942, which resulted in these losses that I have referred to on Exhibit 19. In your opinion would the trade-mark have any fair market value at that time?

A. I am very confident it would not have." [R. 407-408.]

Mr. George Miller, with forty years of experience in the drug business [R. 293] and President of Strong Cobb and Company, the largest private formula manufacturer in the world [R. 292], testified that in the ethical field where the approach is made to the doctor and the product is not advertised to the ultimate consumer, trade-marks or trade names are of very little importance [R. 297-298], and the same can be readily changed with little expense or disturbance of market continuity [R. 299]. The Tax Court found that "The Stuart Formula" was never advertised or sold directly to the public, but only through drug stores [R. 43].

It is admitted that during the period in which Petitioner was the exclusive user of the trade-mark it experienced nothing but increasing operating losses and a growing deficit. *Mertens,* in his *Law of Federal Income*

Taxation, Volume 10A, Section 59.37, at page 76, says that the usual and accepted method of evaluating intangibles such as a trade name is by "(1) determining the average annual net earnings of the business, (2) determining the value of the tangible assets, (3) deducting from the total net earnings the earnings attributable to the tangible property, and (4) capitalizing the balance."

The long-established Bureau ruling is set forth in A. R. M. 34 (2 C. B. 31, 32):

> "The third method and possibly the one which will most frequently have to be applied as a check in the absence of data necessary for the application of the preceding ones, is to allow out of average earnings over a period of years prior to March 1, 1913, preferably not less than five years, a return of 10 per cent upon the average tangible assets for the period. The surplus earnings will then be the average amount available for return upon the value of the intangible assets, and it is the opinion of the Committee that this return should be capitalized upon the basis of not more than five years' purchase—that is to say, five times the amount available as return from intangibles should be the value of the intangibles."

In considering the value of the trade name "The Stuart Formula" we should not lose sight of the fact that Petitioner at all times had the right to use its corporate name "The Stuart Company." It could have sold these better products under its own name or under "Stuart Products." Furthermore, we should not lose sight of the uncontradicted testimony of Mr. Royce and Mr. Miller. Each one of these witnesses testified that there was a great deal of difference between a "trade name" on products sold to the consuming public and a "trade name" on goods sold to doctors and licensed drug stores; that in the ethical

trade it is the product and the integrity of the distributor rather than the trade name that is important in accomplishing sales. The Tax Court specifically stated in its opinion that during the period from May 5, 1941, to October 31, 1942, "17,428 individual doctors had been personally contacted and induced to recommend 'The Stuart Formula' to patients who were in need of additional vitamins and vitamin concentrates under the name 'The Stuart Formula' were being retailed by 6,746 different drug stores" [R. 58]. In short, contrary to the uncontradicted evidence, The Tax Court attached the same importance to a trade-mark used in the ethical field as would be attached to a trade name publicly accepted. In this The Tax Court committed an error. Doctors, unlike the consuming public, do not recommend a mere name; it is the product and the integrity of the distributor that is important in the ethical field.

The method of selling the product by Petitioner clearly supports the unimportance of the trade name. The uncontradicted evidence of Mr. Hanisch was that—

> "* * * all our sales approach was to the doctors, first to establish the reliability of The Stuart Company, secondly to show that we had a greater vitamin potency to offer compared to other products for less money" [R. 167].

The selling chart [Petitioner's Ex. 14] prepared with the help of Dr. Borsook, a professor at the California Institute of Technology, clearly shows that the trade name was insignificant. This chart was used to "show the doctors what vitamin value The Stuart Company had as compared to other products on the market" [R. 168]. This chart showed in dollar value "what the consumer got of all the competing items, and that was our entire sales approach" [R. 168].

Three qualified witnesses, Royce, Miller and Hanisch, testified that the trade name had no realistic value.

Having been responsible for the sales made during the period from May 5, 1941, to October 31, 1942, Mr. Hanisch was certainly in a position to know the effectiveness of the trade name. His experience during this period certainly qualified him best to judge the value of the trade name. It should be obvious that the same results could have been attained by the use of the name "Stuart Vitamins" or merely by the use of the corporate name, "The Stuart Company." This is particularly so since the chief interest of the doctors is in the vitamin content of the product and perhaps its competitive price.

The cheapness of the product was Dr. Borsook's motivating reason for interesting himself in the vitamin business. The idea of his formula, as he testified, was "sociological" [R. 524]. Dr. Borsook further testified:

> "* * * We wished to find a concentrate which was cheap enough for people with ordinary means to use, where abundance of supplies would be available" [R. 524].

The so-called "formula" had little financial value since a similar product could easily have been developed. This is clearly demonstrated by the testimony of Respondent's own witness. Dr. Borsook testified as follows:

> "Q. Dr. Borsook, I understood on direct examination that you stated you were anxious to get this on the market at a low price so that when it was on the market others could imitate it rather quickly and make a wide distribution, so it would increase the nutritional value.
>
> A. I hope I—

Q. I mean increase the nutrition standard.

A. I said I expected that the large distributors, when they saw this product was selling and at a price which was much lower than theirs, they would no doubt, out of sheer reasons of competition, seek to get a similar product. *And I was quite sure the large pharmaceutical houses had technical people who could do it"* [R. 551; emphasis added].

How can it realistically be stated that a trade name of so recent origin on a product which could be so easily developed would have any substantial value is beyond reason. Since the parties to the contract regarded the trade-mark so insignificantly and since the uncontradicted testimony proves conclusively that it had no real value, The Tax Court erred in allocating the sum of $122,700.00 to it.

The Tax Court assumed that the trade name "The Stuart Formula" had a value, since during the period from May 5, 1941, to October 31, 1942, Petitioner made sales totaling $437,613.87, and since 17,428 individual doctors had been personally contacted, and since the product was being retailed by 6,746 different drug stores. Is it reasonable to believe, under these circumstances, that the purchase by each of these drug stores of only approximately $65.31 of the product would establish a value for the trade-mark of $122,700.00? Certainly it takes more than that to establish a value for a trade-mark, particularly in view of the fact that the doctors, as heretofore indicated, were not interested in a name but in the vitamin potency of the product and its competitive price.

The Tax Court in its opinion [R. 58] made the statement that

"* * * During that period [May 5, 1941, to October 31, 1942], 17,428 individual doctors had been

> personally contacted and induced to recommend 'The Stuart Formula' to patients who were in need of additional vitamins and vitamin concentrates under the name 'The Stuart Formula' were being retailed by 6,746 different drug stores. * * *"

An examination of the record fails to disclose that all of these doctors were so induced. In fact, the basis of the Court's statement is found in Mr. Hanisch's testimony [R. 179] where he stated that Petitioner had 17,428 doctors on its mailing list. There is no evidence to support the Court's conclusion that all or any of the doctors had been induced to recommend the use of the product sold under "The Stuart Formula." This should also be considered in connection with the further uncontradicted testimony of Mr. Hanisch that the Petitioner was receiving many complaints from the doctors about the imperfections of the product [R. 157].

Is it reasonable to assume that the trade-mark "The Stuart Formula" had a value of $122,700.00 when, as shown by the record, it had been in existence only approximately 18 months? Is it reasonable to believe that the doctors of this country are so gullible that they would attach importance to a name of such recent origin? Is it reasonable to assume that these doctors would pay such little attention to the quality of the product? The fact that over this 18-month period the sales amounted to $437,613.87 speaks more for the product than the name. This fact is clearly established by the record. Is it reasonable to assume that with a superior product, which as

the record shows Petitioner could obtain elsewhere and at at least half the cost, the same or better results could not be obtained during a similar period of 18 months, even with a new and different name? Mr. Hanisch's testimony as to the cost of establishing such a name is uncontradicted. It is factual, and clearly and convincingly establishes that no greater part of the contract consideration should properly be allocated to the trade name "The Stuart Formula" than the amount of $20,000.00, if any allocation is to be made.

It should be remembered that:

> "As part of the settlement agreement between the petitioner and Vita-Food, Vita-Food assigned to Hanisch 300 shares of stock of the petitioner which had been issued to Maxwell H. Lewis as representative of Vita-Food. * * *." [R. 59.]

Recognizing the rule of law laid down in *Cleveland Allerton Hotel v. Commissioner* (C. C. A. 6), 166 F. 2d 805, The Tax Court properly allocated no part of the consideration to this stock. Such action of The Tax Court was based upon its findings that the stock had no value, as indicated by the following excerpt from the Court's opinion:

> "* * * The petitioner introduced competent evidence that this stock had no value on November 28, 1942, and respondent has made no contention that it did have any value. We have found as a fact that the 300 shares of stock assigned by Vita-Food had no value, and no part of the total consideration paid by the petitioner under the contract of November

> 28, 1942, with Vita-Food is properly allocable to the purchase of these shares of stock." [R. 59.]

This finding of The Tax Court was based upon the testimony of Mr. Hanisch, which the Court recognizes as "competent evidence." Why his testimony with respect to the value of the trade name should have been disregarded is difficult to understand, especially since it is supported by other witnesses who had no connection with Petitioner. The Respondent offered no evidence as to the value of the trade name, as he offered no evidence with respect to the value of the stock, and it therefore must be assumed that he had no evidence to offer as to the value of the trade name.

Reasonable people do not pay $122,700.00 for a name that can be replaced and built up by the expenditure of approximately $20,000.00. The value of a name under these circumstances does not realistically attain such an astronomical value, particularly where the sales promotion is confined to doctors and licensed drug stores. The record clearly shows that what Petitioner was acquiring was the release from an onerous contract which required Petitioner to confine its merchandise purchases to the products manufactured by The Vita-Food Corporation and at a price approximately more than 50 per cent higher than that at which Petitioner was able to obtain better products from others. That is the essence of the "Agreement of Settlement of Litigation and Cancellation of Contract." It is therefore respectfully submitted that the Court erred in allocating to the trade name "The Stuart Formula" the sum of $122,700.00 or any substantial part thereof.

E. **The Tax Court Erred in That Its Ultimate Finding That the Sum of $122,700.00 Should Be Allocated to the Trade-mark Is Inherently Improbable and Conflicts With the Specific Findings.**

The Tax Court specifically found that the 300 shares of Petitioner's stock were valueless on November 28, 1942. [R. 56.] In logical support of this finding the Court found that Petitioner had sustained net operating losses totaling $15,451.56 during the period from May 5, 1941, to October 31, 1942. The Tax Court also found that in September, 1942, Mr. Hanisch had discovered that similar vitamin products could be obtained for approximately one-half the price that Petitioner was obligated to pay The Vita-Food Corporation.

There is no finding of fact nor is there any evidence in the record that the trade-mark "The Stuart Formula" did have any real or intrinsic value on November 28, 1942. The overt evidence is that it had no value and this evidence is uncontradicted. The Tax Court, without a supporting finding, or any explanation or reference to particular evidence, simply concluded that Petitioner paid the sum of $122,700.00 to acquire the name [R. 56-59].

This conclusion is arbitrary and the finding is entirely inconsistent with the specific findings above referred to. The Tax Court erred in failing to particularly find that the trade-mark had no value. The Tax Court could not as a matter of law conclude that Petitioner paid anything for the trade-mark, if it had made a finding, as it was requested and required to do, that the trade-mark had no value.

It is inherently improbable that Petitioner would have paid $122,700.00, or anything more than a very nominal amount, for the trade-mark when its officers considered

the trade-mark to be without value [R. 179-180] and when their experience with the trade-mark had produced nothing but losses [Petitioner's Ex. 19]. On the other hand, it is conclusively logical that Petitioner would pay and did pay the entire consideration of $197,700.00 for release from the onerous terms of a ten-year contract [Petitioner's Ex. 8] which required Petitioner to expend from forty to fifty per cent more [R. 49] for an inferior product [R. 135 and 202; Petitioner's Ex. 20] than would be required to secure a reliable product from a reputable manufacturer [R. 143], and which required Petitioner to purchase all of its merchandise from The Vita-Food Corporation.

We are aware of the rule that it is not the function of this Court to weigh the evidence, but certainly the Court is not bound by an arbitrary finding, contrary to the evidence, and based upon a conjecture which is inherently improbable. Such a finding is "clearly erroneous" within the meaning of that term as it is used in Section 52(a) of the Rules of Civil Procedure.

In *United States v. United States Gypsum Co.,* 333 U. S. 364, 395, the Supreme Court stated the governing rule on appeal to be as follows:

> "* * * A finding is 'clearly erroneous' when although there is evidence to support it, the reviewing court on the entire evidence is left with the definite and firm conviction that a mistake has been committed."

In *Howell Turpentine Co. v. Commissioner* (C. C. A. 6), 162 F. 2d 316, the Circuit Court set aside the judgment of a majority of The Tax Court for the reason that it was based upon an inference which was contrary to the

uncontradicted sworn testimony. The Court said, at page 326:

> "* * * The sworn testimony precludes by a principle of law the inference to the contrary which the majority sought to draw. * * *."

The finding of The Tax Court that Petitioner paid $122,700.00 to The Vita-Food Corporation for a valueless trade-mark is "clearly erroneous." But, as heretofore stated, the only basis to allocate any part of the contract consideration to the trade name "The Stuart Formula," if any such allocation should be made, is the testimony of Mr. Hanisch that it would cost not more than $20,000.00 to develop a name [R. 180].

The Petitioner submits that the determination by The Tax Court that Mr. Hanisch and The Stuart Company were obligated to pay $122,700.00 for the trade-mark "The Stuart Formula" was, and could have been, arrived at only as a result of misinterpretation of the facts and misconstruction of the testimony, and that the testimony must be evaluated in the light of the weakness of the Government's position. The point here under consideration is phrased in the California Code of Civil Procedure, Section 1963.6 "that higher evidence would be adverse from inferior being produced," or to rephrase the contention, it is significant that the convincing evidence was not produced and that the Court relied upon the analysis of the facts which themselves were misinterpreted.

Certainly the Respondent cannot now complain, since—

(1) No Government witness testified that the trademark had any value as such.

(2) No person acting in the drug business testified to the importance of a trade-mark in distributing ethical items.

(3) No witness disputed the testimony of Messrs. Hanisch and Miller to the effect that it is the representation and responsibility of manufacturerers or distributors, as the case may be, rather than a trade name which causes acceptance of pharmaceuticals.

(4) No witness testified and no authorities were cited, and we submit that none can be, of prices paid for trademarks even in situations of successful businesses.

(5) No successful businessman or intermediary endeavored in any respect to refute the testimony of witness Hanisch as to methods of doing business and costs of established "circulation" of an ethical drug item.

(6) No testimony was produced to refute the statement of George Miller [R. 297] that "there is quite a distinct difference between what we called a so-called trademark and the proprietary or patent medicine field"; and the statement [R. 298] "you have got an entirely different value between trade names in the ethical field and trade names in the patent medicine or proprietary."

From the foregoing omissions, which are illustrative only, it is submitted that evidence of the above and comparable character which was not produced is of greater effect than the self-serving declarations which were produced by the Government and which of themselves will not substantiate either the findings or the conclusion of The Tax Court therefrom. We submit further that the entire approach of the Government to the problem under consideration is refuted in the lack of realization of the true facts disclosed in the cross-examination by the Government counsel of witness Hanisch [R. 224].

> "Q. Now, Mr. Hanisch, I believe you stated that one thing about the financial stability of the Vita-

Food Corporation that had you worried, was in connection with the explosion of these bottles; that you didn't want to have to assume the financial responsibility in connection with exploding bottles and returned merchandise, is that right?

A. That is correct.

* * * * * * * *

A. * * * I felt that if at some time we had a terrifically large return and the company, Vita-Food Corporation, were not capable—if they were not in a good financial position, I had no recourse. * * *

Q. Now, I am going to ask you to look at the contract of May 5, 1941, and see if you don't find in there, a specific provision that the Vita-Food Corporation would carry insurance with respect to those products, and covering the very thing about which you have just now testified?

A. I know the situation you refer to * * *

* * * * * * * *

A. I think you have a misconception of what product liability insurance is. Product liability insurance means this: That, if you or your child would swallow some of this [182] stuff and you are injured, you have insurance on that, but it does not provide for bad merchandise. Say, if $20,000.00 of it blew up, or I had to return it, it does not insure against a return of merchandise. * * * It would not cover what you are talking about." [R. 223-225.]

The same type of misconception of the realities of the transaction permeated the entire presentation and it is submitted that The Tax Court was mislead into misinterpretation of the realities of the situation confronting the parties when the settlement agreement was executed. We repeat those realities at this point, as follows:

The Stuart Company had on November 28, 1942, been in existence only since March, 1941. Its first shipments

were not made until May 15, 1941. It was obligated under an insufferable contract with impossible quotas to purchase inferior merchandise from a secretive manufacturer at double the cost at which acceptable drugs could be obtained from reliable pharmaceutical manufacturers [R. 49].

Whether it used the name "The Stuart Formula" or not it could make no purchases from anyone other than The Vita-Food Corporation. Its losses amounted to $15,-000.00. Its relations with the other parties of the contract were strained and unsatisfactory. It had been purchasing a product which was not the product it believed it was buying. There was no secret formula. Unless in some way it could avoid further entanglement with The Vita-Food Corporation, its past experience demonstrated that it could look forward to nothing but continued losses. Its sales policy and its selling prices were under the domination of a party whose competence and integrity The Stuart Company distrusted. Mr. Hanisch, whose name had not theretofore been connected with a failure, loaned to the company $70,000.00 which could not be recovered unless relief from the contract was obtained. He was therefore in jeopardy not only for the loss of his investment, but the situation confronting the parties was even more desperate in that Mr. Hanisch had not received any salary.

These considerations, and these considerations only, were the motivating cause for the execution of the settlement agreement which the witness Wiseman testified was intended to mean what it said and which agreement nowhere purports to sell a so-called capital asset for $122,700.00 or any other sum.

II.

The Trade-mark in the Hands of the Vita-Food Corporation Was Worthless as a Matter of Law and They Had No Legal Right or Effective Ability to Execute an Assignment.

The Petitioner was the sole, only and exclusive user of the trade-mark "The Stuart Formula" [R. 130]. The name of The Vita-Food Corporation did not appear on the label [Petitioner's Ex. 9] or on any correspondence or literature [R. 130]. The Tax Court made the statement in its opinion that much good will had been built up, and poitned out that 17,428 doctors had been personally contacted and the product was being retailed by 6,746 different drugstores on October 31, 1942 [R. 58]. For the sake of argument only, let us grant that there was theoretic or potential good will—but whose good will? The Vita-Food Corporation never claimed to own any good will. Its name was utterly unknown to the doctors and drug outlets, and only Petitioner's name, "The Stuart Company," through Petitioner's representatives, was associated with the product. Any good will which may have existed was in connection with merchandising methods, personal contacts, trade lists, and demonstrated integrity. It was the exclusive property of Petitioner. There is no contrary claim or assertion in the record and none could exist in reason or logic.

What then did The Vita-Food Corporation purport to own on November 28, 1942, as a matter of law, by its claim that it owned the trade-mark? In *Nims on Trade-Marks* page 506, Sec. 188, it is said:

> "The trade-mark is the expression, the symbol, of part or all of the good-will of the business using the

mark. Separate from the good-will of the business it identifies, a trade-mark is useless, valueless."

The Supreme Court of the United States has said:

> "* * * There is no property in a trademark apart from the business or trade in connection with which it is employed. * * *"
>
> *American Steel Foundries v. Robertson*, 369 U. S. 380, citing many supporting authorities.

See also, the following comment at 26 R. C. L. 838:

> "The right to a trademark or trade name cannot exist as a mere abstract right, independent of or disconnected from the business in which it is used."

The Vita-Food Corporation purported to own something on the critical date, and The Tax Court has found that it conveyed something, which under the circumstances they could not legally or effectively possess at that time. They lurked in the background cloaked in militant anonymity. The very whereabouts of their manufacturing plant and laboratory were never disclosed even to Petitioner [R. 169] for undoubtedly good, but unexplained, reasons [R. 615]. There can certainly be no good will connected with that which is completely unknown, and we have found that a trade name is not property and cannot exist as a matter of law separate and apart from the business with which it is associated.

The case of *Distillers Brands, Inc. v. American Distilling Co.*, 26 Fed. Supp. 988, presented to the Court a strikingly similar fact situation. In that case, the distiller or manufacturer of bulk whiskey bottled and sold the same to its distributor. The distiller originated the trade name "King's Pride" and designed the label which was placed on the bottle. After the distributor had used

this trade name in its business for a short time it began making purchases of whiskey from another distiller, and directed the second distiller to label the product "King's Pride" in the same manner. The original distiller sought an injunction and an accounting of profits because of alleged infringement of trade-mark and unfair competition. The Court succinctly stated the applicable law as follows:

> "* * * Where a trademark indicates a distributor of merchandise rather than the maker, it is the distributor who acquires the trademark rights. For the public associates the goods so marked with the distributor and knows not the identity of the maker. * * * The fact that it was the plaintiff who suggested the adoption of 'King's Pride' as a trademark for the King Company amounts to nothing. The plaintiff was bound to know that the trademark as shown on the labels would become the brand of the King Company. So the plaintiff had no trademark rights in King's Pride whiskey."

It might be that The Vita-Food Corporation owned the trade-mark in a very technical sense when the contract of May 5, 1941 [Petitioner's Ex. 8], was executed, if in truth the officers of The Vita-Food Corporation conceived of the trade-mark as they claimed [R. 577, 578]. It might be that the contract itself vested ownership of the embryo trade-mark in The Vita-Food Corporation, but as pointed out by the Court in the above-quoted case they were bound to know that the trade-mark would become The Stuart Company's property by virtue of its use where the manufacturer was anonymous so far as the consuming public was concerned. At least they were bound to know that whatever hollow right remained in their hands was not valuable property and could not be effectively sold or assigned by them in gross or wholly apart from the busi-

ness or good will of which it had become an inseparable part.

What happens as a matter of law (California law) if one attempts to sell or assign the naked title to a trade-mark.

> "* * * Appellant urges as a ground for reversal that a trade-mark or name cannot be sold or assigned except in connection with an assignment of the particular business in which it has been used. With this statement we agree * * *. '* * * The physical elements or assets of a business may not be sold to one and the good will and trade-name thereof to another, for, when the good will and trade-name is separated from the business to which it applies, it is thereby destroyed, and cannot thereafter be the proper subject of a sale. * * *' * * *
>
> For these reasons the defendants owned nothing which they could be required to separately transfer to the receiver, and their assignment to the receiver passed no title. *In re* Jaysee Corset Co. (D. C.), 201 F. 779; 63 Cor. Jur. 513. 'It may be stated as a general rule that a trademark or trade name is not an article of property that passes from hand to hand by assignment separate from the business of the owner of the mark or name, but that, in order to convey the right of user, *the transfer must be coupled with the transfer of some product or business with which it has become identified.* * * *'" (*Ward-Chandler Bldg. v. Caldwell,* 8 Cal. App. 2d 375, 47 Pac. 2d 758 at p. 760—emphasis added.)

The law of California is generally accepted and has been accepted by the Circuit Courts of Appeal and The Tax Court as controlling in tax cases. See *Sommers v.*

Commissioner (C. C. A. 10), 63 F. (2d) 551 at page 552 where the Court said:

> "* * * Good will is not susceptible of separate ownership or transfer. It arises only out of a particular business, and has no existence apart from it. * * *"

And also see *Estate of Henry A. Maddock, et al. v. Commissioner,* Docket No. 25890, 16 T. C. No. 41, promulgated February 15, 1951, where the Court held:

> "* * * However, in fixing the value of the good will of a business, it is equally important to recognize that good will exists as a valuable asset only as an integral part of a going business and cannot be sold, donated, or devised apart from the going business in which it was developed and to which it is thereafter inseparably attached. * * *"

In the Cancellation Agreement of November 28, 1942 [Petitioner's Ex. 12] there is certainly no suggestion, nor is there any suggestion in the record or findings of The Tax Court that The Vita-Food Corporation was selling any formula, product or business, or any tangible or intangible thing, with which the trade-mark had been associated. There was merely a casual quitclaim of the trade-mark, without warranty, and a promise to execute an assignment, if requested.

But this action is entirely consistent with the rights and interests of the parties in the premises. The trade-mark was valueless, as we have seen. In the hands of The Vita-Food Corporation it was not property, and they could not execute an effective assignment under California law. But the trade mark was registered in their name [Petitioner's Ex. 15] fraudulently or not, and a simple

quitclaim or formal assignment would be a logical step in forever "divorcing" the parties, one from the other.

The Tax Court has arbitrarily determined that Petitioner paid a substantial sum of money to purchase a thing which was valueless from a "seller" who as a matter of law could not own it or execute a valid assignment. In other words, The Tax Court has found that Petitioner paid the sum of $122,700.00 for a nullity.

Conclusion.

There is no substantial evidence or evidence legally sufficient to sustain the finding of The Tax Court that Petitioner paid the sum of $122,700.00 to purchase a trademark. The finding is arbitrary.

In arriving at the finding the Court ignored fully corroborated and uncontradicted evidence, which, if considered at all, would preclude such a finding. Evidence which is material, relevant, probable, consistent, uncontradicted and not discredited cannot be disregarded or ignored by the Trial Court. The ultimate result reached by The Tax Court is inconsistent with its specific findings and based upon a conjecture which is inherently improbable. The decision is erroneous as a matter of law and must be reversed.

Dated June 1, 1951.

Respectfully submitted,

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